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RUEHLP/AMEMBASSY LA PAZ 4450
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C O N F I D E N T I A L SECTION 01 OF 05 BRASILIA 000608

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SUBJECT: BRAZIL - AN EARLY LOOK AT ECONOMIC ISSUES IN THE 2006
PRESIDENTIAL CAMPAIGN (C-AL6-00372)

REF: A) STATE 39813

B) BRASILIA 0546

C) 05 BRASILIA 0521

Classified by Economic Counselor Bruce Williamson, reasons 1.4
(b) and (d).

¶1. (C) Summary: In sharp contrast to Brazil's 2002 presidential election, in which Lula da Silva and the leftist Workers' Party (PT) emerged victorious, the 2006 presidential elections carry much less uncertainty about future economic policies. Lula has established a surprisingly strong record of orthodox macroeconomic management and pursued, albeit with less success, necessary microeconomic reforms. His principal opponent in the elections, Sao Paulo Governor Geraldo Alckmin, of the opposition Social Democratic Party (PSDB), also has a record of sound fiscal management at the state level. While not an economist, Alckmin has called for a "capitalism shock" to boost economic growth and has begun to gather around him a team of advisors that includes players from the Fernando Henrique Cardoso administration. Although neither Alckmin nor Lula (who has not yet formally declared his candidacy) has elaborated an electoral platform, from the point of view of macroeconomic policy both look like candidates of continuity. But there are differences in their likely agendas for microeconomic reform, some of which will affect U.S. interests, such as trade liberalization. How much of their agenda either candidate will implement will depend in large part on their mandate and the coalition politics of the next Congress, both of which remain big unknowns. End Summary.

¶2. (C) This cable is a partial response to ref A request (C-AL6-00372). Septel will address political issues.

PSDB's Alckmin not an Economist, but a Capitalist

¶3. (C) Raul Velloso, a prominent fiscal expert linked to the opposition Social Democratic (PSDB) party, shared with Econoff his reflections on the economic policies that Sao Paulo Governor Geraldo Alckmin would likely pursue if elected, as well as his views of what a potential second Lula term would look like. Velloso confirmed press accounts that Alckmin has consulted him on economic issues and that he has become one of the Governor's regular tutors, helping Alckmin, who is a medical doctor by training, puzzle through complex economic issues. Velloso stated that Alckmin has made a point of consulting widely with the leading economists in the PSDB, including many members of the administration of former President Cardoso. Other analysts have noted Alckmin's closeness to the Sao Paulo business community, and in particular the Sao Paulo State Industry Federation (FIESP).

¶4. (C) Velloso labeled Alckmin a "traditional" politician, albeit a "serious, well-intentioned" one. He loves to wade into crowds and knows how to connect with people, Velloso affirmed. As Governor, Alckmin established a strong record of fiscal discipline, effectively containing costs. Alckmin, however, does not have an instinctive feel for the bigger-picture macroeconomic issues he would face on the presidential campaign trail. By contrast, he easily perceives the political consequences of policies, quickly understanding what interest groups stand to gain or lose from a given economic policy stance, according to Velloso. Alckmin, for example, easily identifies the political costs of maintaining high primary surpluses, Velloso noted, but like many politicians, he has difficulty understanding the linkages between fiscal and monetary policy and their implications for the contentious issue of high real interest rates in Brazil. Alckmin nevertheless is

BRASILIA 00000608 002 OF 005

tenacious in seeking to understand important economic issues, Velloso said.

Alckmin - Managerial Decision-Making Style

¶5. (C) Velloso judged that Alckmin's personal traits and preferences make his approach to economic decision-making reminiscent of former President Fernando Henrique Cardoso, who relied on the majority opinion among his advisors. Other observers, including the IMF resident representative, have echoed this assessment, noting that one of Alckmin's strengths is his ability to select good advisors. Indeed, economic counsel is one commodity that the PSDB does not lack; the party counts among its members many of the prominent orthodox economists in the country. According to the press, Alckmin in recent weeks has held discussions with notable PSDB economists Edmar Bacha, Arminio Fraga and Luiz Carlos Mendonca de Barros. Bacha, a well-known professor of economics at the Catholic University of Rio de Janeiro (PUC-RIO, a common point of reference for many PSDB economists), became part of the team that launched Cardoso's "Real plan" and later served as President of Brazil's Social and Economic Development Bank (BNDES). Fraga is best known for his role as president of the Central Bank from 1999 to 2002.

¶6. (U) According to press reports, Alckmin also frequently consults Yoshiaki Nakano on fiscal issues. Nakano, a professor at the Sao Paulo branch of the Fundacao Getulio Vargas (FGV), is credited with cleaning up Sao Paulo state finances as an aide to Alckmin's political mentor, the late governor Mario Covas. Mendonca de Barros, another former BNDES president known to be close to the Sao Paulo business community, is singled out by another press report as having become one of Alckmin's economic advisors.

Macroeconomic Continuity

¶7. (SBU) The direction of the economy under an Alckmin government may not differ that much compared to Lula. In

Brazil, the embrace of sound macroeconomic policies is no longer particular to one specific candidate or party, but instead has become institutionalized, JP Morgan President Charles Wortman declared to Econoff on March 20. This, along with Brazil's solid macroeconomic fundamentals and continued strong international liquidity, was the reason financial markets barely blinked on March 16 when yet another witness accused Finance Minister Palocci of involvement in illicit activities. Financial market participants expect continuity of policy even were Palocci to depart, Wortman affirmed, because the healthy economy has been Lula's biggest accomplishment. (Note: On March 27, Finance Minister Palocci did indeed resign. See septel for further analysis of the implications of Palocci's exit for the Lula government.) IMF Resident Representative Max Alier likewise assessed that Lula would maintain the same overall policy stance for the remainder of his term and, if he were re-elected, during his second term.

18. (SBU) While Alckmin has a clear track record of strong fiscal management, there is less basis upon which to evaluate his views on monetary policy. The IMF's Alier expressed confidence to Emboff that while he lacked formal economic training, Alckmin would heed sound advice. Among the economists that Alckmin has been consulting frequently, none is publicly advocating significant changes to the monetary policy framework. All would maintain the Central Bank's inflation targeting regime, although Mendonca de Barros, arguing that Brazil is currently in a

BRASILIA 00000608 003 OF 005

virtuous cycle of low-inflation growth, believes the Central Bank could be much more "flexible" in bringing interest rates down. He has called for real interest rates to fall to 5 percent by 2009.

19. (SBU) CSFB Chief Economist Nilson Teixeira voiced some concerns to Econoff in a March 17 conversation that the Finance Ministry's steely fiscal discipline might fray around the edges during the remainder of Lula's administration (or in a second Lula administration) were Lula to name a political figure as finance minister. (Currently, its unclear whether Palocci's replacement, Guido Mantega - previously Lula's Minister of Planning and President of the National Development Bank - fits that bill or not.) Teixeira worried that in this scenario, and with senior technocrats such as Treasury Secretary Joaquim Levy set to leave the ministry, there would no longer be a voice of fiscal restraint within the Finance Ministry.

Lula II - Less of a Mandate for Reform

10. (SBU) Lula has accomplished more on microeconomic reform than anyone would have expected in 2002 but far less than his administration set out to do (ref C). Lula made an early positive mark in 2003 by obtaining passage of social security reforms that stabilized the deficit in the public employees' pension system. The GoB also undertook tax reform in 2003, making the PIS and COFINS taxes more VAT-like. In 2004, the GoB achieved Congressional passage of a new bankruptcy code, a legislative framework for public-private partnerships in infrastructure investment, and a controversial overhaul of the regulatory framework for the energy sector. An important set of judicial reforms also was enacted, which included measures that, over time, should improve the predictability of the judicial system.

11. (SBU) In early 2005, the PT bumbled its way to losing elections for the speaker of the Chamber of Deputies. Since then, very few administration priorities have made it through Congress. The ongoing political scandal over vote buying, influence peddling and irregular campaign financing erupted soon after that, further reducing Lula's ability to move legislation through Congress. Since May 2005, the only microeconomic legislation to pass has been a set of targeted tax benefits for exporters which garnered enough industry support to skate through Congress.

¶12. (SBU) Reflecting wryly on Lula's surprising rebound in the opinion polls, Velloso said that the PSDB had allowed itself to believe that its choice of presidential candidate would determine the next president. Lula, however, had successfully cleansed his image by shifting blame to the PT for the interlaced corruption, vote buying and influence-peddling scandals that engulfed his administration in the second half of ¶2005. That approach -- combined with Lula's personal charisma and carefully managed public appearances -- had allowed Lula to convince his core constituency that he was above the scandal. Velloso argued, however, that Lula's strategy, while opening up the possibility of reelection, nevertheless carried significant risks. Principal among these, Velloso believed, was the weakening of the PT and a strong possibility that Lula would have less of a mandate in the second term. In addition, Lula would have to rely even more on coalition partners, as some analysts here predict that the scandal-tainted PT could elect as few as 50 federal deputies (out of 513 total) in the upcoming October elections. Velloso therefore predicted Lula would have at best limited success in pursuing the microeconomic reform agenda necessary to improve productivity and growth rates.

BRASILIA 00000608 004 OF 005

Alckmin vs. Lula on Micro Reforms

¶13. (C) Below are some of the principal microeconomic issues the candidates will have to deal with:

Trade Liberalization -- While the GoB has engaged constructively in the WTO Doha round, the GoB has allowed negotiation of the Free Trade Area of the Americas (FTAA) to languish. When unscripted, Lula has gone so far as to say that FTAA is not on his agenda. Velloso assessed that an Alckmin administration would be much more likely to seek to reenergize the FTAA process. In public comments, Alckmin has stated that he believes Brazil needs trade liberalization to boost competitiveness and specifically mentioned renewing FTAA negotiations as a priority. On process issues, FIESP contacts have told us that Alckmin would reorganize the GOB's decision-making apparatus to take responsibility for trade negotiations out the hands of entrenched diplomats at the Foreign Ministry and lodge it with a newly-created interagency body (very much equivalent to USTR).

Tax Reform -- the Lula administration changed the PIS/COFINS taxes in 2003 to make them more VAT-like. While it had planned a badly needed overhaul of the state-level VAT system (ICMS), political considerations forced the GoB to abandon this effort. Unable to pursue broader based reforms, the Lula administration instead enacted several targeted tax measures, aimed variously at promoting exports, fostering innovation, developing real estate markets, creating new financial market products and facilitating capital equipment upgrades. Velloso stated that Alckmin likely would pursue broad-based tax reform, which necessarily would include a reduction in mandatory transfers to state governments to allow the federal government to reduce taxes.

Social Security -- The social security system deficit is growing despite previous efforts at reform. A big part of the problem this time, according to Carlos Mussi of the UN Economic Commission for Latin America (ECLAC), is that the Lula administration granted substantial real increases in the minimum wage in 2004 and 2005. As pensions are by law indexed to the minimum wage, social security accounts have suffered. Given the potential political down-side of tinkering with social security during an election year, we anticipate that both candidates will largely remain silent on this issue during the campaign and only reveal their true agenda after the election.

Interest Rates -- Brazil's high real interest rates are likely to be the most controversial economic issue of the campaign. Alckmin's stance, however -- that the government's borrowing requirement must be reduced through expenditure cuts in order to

allow interest rates to fall -- differs little from what Lula would have to do if he is reelected. (Very likely, a constitutional amendment would be required to do away with constitutional earmarks and allow the GoB to reduce non-discretionary spending.) Neither candidate has, to date, mentioned the need to reform the directed credit system (for example, to agriculture at low interest rates), which effectively increases interest rates for all other borrowers.

¶14. (C) Comment: The fact that an unabashedly pro-business candidate like Alckmin may have difficulty differentiating his economic agenda from that of the nominally leftist President is illustrative of how little uncertainty exists on the overall economic policies to be followed in Brazil after this election. This reflects in part the societal consensus in favor of sound

BRASILIA 00000608 005 OF 005

macroeconomic management that the still-present memory of hyperinflation past has helped to create. It also shows the degree to which many reforms have become institutionalized, particularly those introduced by the fiscal responsibility law. How much of his microeconomic reform agenda either candidate will in fact be able to accomplish is an open question, which will depend to a significant degree on post-election coalition politics. To date, the principal economic policy difference between the two that stands substantially to impact USG interests is Alckmin's stated emphasis on re-energizing FTAA negotiations.

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